



Retrospective 2011

In this note we review our thoughts and predictions we made at the beginning of 2011.

For all intent and purposes 2011 was looking to be another year of recovery for global economies and the financial markets. How wrong this was. The optimism enjoyed in the first months of the year evaporated quickly as global economies were battered by civil unrest in North Africa, a Japanese earthquake of Nuclear proportions and the developing crisis in Europe. Never one to hide behind the annals of time we present, as we do every year, our January 2011 Outlook note and throughout this document critically assess the accuracy of our thoughts and predictions.

What did we suggest may happen to investment markets in 2011?

EQUITY MARKETS

In January of 2011 we predicted “a third year of solid gains” and “A concerted effort by central banks and governments around the world to underpin the current recovery” with “similar volatility that we witnessed throughout 2010”. Although the anticipated gains failed to materialise the central bank

intervention and high levels of volatility did. Despite starting the year positively the earthquake and subsequent Tsunami in Japan mid-March knocked stock markets from their highs. In spite of this markets had regained some composure by the summer with signs of a rally in equities evident in July in the wake of a renewed appetite for risk. But the real turning point, and the real culprit for 2011, came in August in a rapid deterioration in confidence as the Euro zone debt crisis took a new and dramatic twist, turning a debate about peripheral debt and, nominally speaking, an economic irrelevance into a full blown crisis. The method by which contagion spread to include the core Euro zone economies had at its heart the interdependence of the entire financial system which was already well understood. Volatility ballooned.

The paradox, of course, is that fears of a sovereign bond default saw investors flee from equities into the perceived safe haven of core Euro zone bonds and non-Euro zone bonds (UK Gilts and US Treasuries). As we wrote in our note "Risk-on, Risk-Off" in June 2011, the behaviour of market changed to one with a very short term mindset trading on news flow, mostly emanating from issues connected with comment from the Euro zone. The second half of 2011 was a frustrating and unrewarding time for stock picking investors as money flowed back and forth en-masse. Volatility was exceptional and untradeable. Corporate earnings and forecasts for 2012, which were consistently better than expected, particularly the US, tended to get overlooked in the short term. At the same time, however, away from the geo-political noise economic indicators such as housing and unemployment showed signs of recovery and this improving macro-economic backdrop gave some support to equities which, in the US at least, finished the year almost exactly where they started.

Internationally we withdrew from Europe only maintaining limited exposure to Japan and the United States.

Japan did indeed enter a technical recession (two quarters of negative growth) in the aftermath of the earthquake and tsunami by virtue of the fact that GDP in the fourth quarter of 2010, which pre-dated the disaster, had already logged a 1.1% decline. We concluded that, in our experience, Japanese equities tended to overshoot on the downside during volatile and uncertain times. This is exactly what happened but the relief rally was sufficiently large and the situation surrounding the Fukushima nuclear reactors still so uncertain that we took the decision to exit the Japanese exposure with the broad Topix Index trading around 866 at the end of March. We were also conscious of the Sterling hedged nature of the investment with the Yen having been immediately sold quite heavily following the disaster. This knee jerk reaction was not wholly unexpected but it was always likely that there would be some degree of repatriation of the Yen by financial institutions from their foreign carry trade investments, not least of all by Japan's domestic insurers, which would ultimately lead to Yen strength. We stand by our assertion from this note that Japanese equities represent good value relative to other developed markets and re-entered an un-hedged position in August which has benefited from the flight to non-Euro investments.

Further Indecision in the US regarding extension of their debt ceiling limit, and a deterioration of the Euro zone debt crisis, proved a perfect backdrop for a summer sell off with equity markets falling nearly 20%! Despite these falls we maintained our core equity holdings but trimmed a number of European focused and higher beta funds that we believed offered a significantly negative risk reward ratio given the rapidly changing market environment. "Operation Twist" launched by the US Fed late September buoyed

markets though its effects were short lived. This did, however, offer us the indicator to re-enter the US equity market as part of our much reduced international exposure. Our newly added US income focused fund proved one of the strongest performers over the final months of the year, as a strong US corporate earnings season and a distance from European issues benefited US markets.

During this period we added to another of our themes for 2011 “leadership from larger capitalisation stocks able to benefit from global economic stability” through the addition of a fund focusing on large capitalisation income generative companies. Indeed, this fund, a name we had visited in the past but out of favor for many months proved one of the bright spots across all equity markets sectors.

The rest of the year was dominated by rescue and bailout talks throughout Europe culminating in global central bank cooperation to provide liquidity to financial markets. Equity markets regained some poise during this period though some remain significantly below their starting levels. We ended the year with a generally underweight exposure to equity market having switched the focus to more income generative and defensive situations concerned that the salvo of silver bullets directed at the markets would not ultimately have the desired effect.;

FIXED INCOME MARKETS

In 2010 we wrote “In 2011 we view the fixed income market, therefore, as one that offers a more ‘trading’ opportunity than a long-term buy and hold investment.” How true that proved. Our overall negative stance on fixed income based on an assumption of higher inflation throughout the year (a 100% correct call with inflation in the UK hitting 5.4%, way the Bank of England’s target rate) proved as right as it was wrong. During the first quarter our markets behaved as we anticipated with bond yields generally rising, eroding capital casing and producing negative returns. However, the Japanese Tsunami and the other catalyst of uncertainty discussed above produced the surge to “safe haven” investments, reminiscent of the last recession, with investors rushing in to the UK sovereign debt market; un-phased by the negative real yields on offer. This buying pressure, assumed by many, to be short-term in nature (Bill Gross, legendary manager of the PIMCO Total Return fund one of the largest in the world, underestimated the surge in government securities and apologised to investors during the year), persisted throughout the year resulting in the sovereign debt market being the strongest performing asset class during the year.

Having started the year with a very bearish allocation to sovereign debt we selectively added first short-dated, then broader allocations to UK Gilts as the year progressed. Given the large component of such securities contained within the majority of our portfolio benchmarks our comparative performance suffered as Gilts rallied. In August we issued the note “Gilt-y as Charged” where we highlighted the markets prevailing attitude to the asset class. Much like 2010 we maintained our conviction with this stance, but unlike the previous year, we were beaten by the calendar, with the expected pull back in bond prices now looking more likely in 2012 – a theme discussed in our Outlook for 2012.

Despite the rise in Gilt prices, other bond markets did not fully participate in the rally as credit spreads rose between the highest and lower grade securities. The higher-grade corporate bond sector was a positive performer during the year as opposed to high-yield sector which suffered greatly. Possible spread contraction will be a prominent investment theme next year, again discussed in our Outlook

document.

PROPERTY MARKETS

At the beginning of the year we wrote “Given our negative short-term outlook for the sector and fears that we again may witness detrimental liquidity issues we are not recommending any property exposure at this time. However, should either the market fundamentally improve or we identify a compelling short-term opportunity (as in 2010) we may enter the market in a limited way.” Our view on the sector did not change significantly during the year fearing that the euro crisis and concern that the UK may slip back into recession the following year hurt demand for assets in all but the best locations. The two-year recovery in UK shops, offices and warehouses slowed the second half of the year though prices indices did not actually decline until November; for prices and rents to rise you generally need the economy to be positive and have GDP growth; both of which looked less likely as the year wore on.

However, we did identify some short-term opportunity in the commercial “bricks and Mortar” sector and entered the asset class with a nominal weighting. In times of economic uncertainty investors focus on the best properties in the prime locations, and the strongest covenants and we were at pains to review the quality and depth of tenancy before committing to investments. These investments have proven resilient in comparison to other asset classes.

ABSOLUTE RETURN

In January we wrote that “we view Absolute return funds as a recommended core asset class in its own right and, for 2011, as a suitable substitute investment for our underweight fixed income exposure. By selecting appropriate funds we aim to create a bond-like return (under normal positive bond conditions) and are therefore recommending an overweight allocation this year. Further we expect even more funds to be launched throughout the year and envisage a more comprehensive strategy classification system to be introduced.”

Absolute Return funds remained a core holding within our portfolios and whilst producing lower correlations and better returns than equity markets could not act as the bond substitute we originally intended given the out-sized gains enjoyed in the sovereign debt markets.

COMMODITY MARKETS

For the year we speculated that “COMMODITY MARKETS will remain fractured with clear winners and losers during the year.” Further we speculated that “Precious metals, for example, will be continued beneficiaries of the increased demand” and that “The still positive dynamics which look certain to propel crude oil back over the \$100/barrel mark, such as limited supply and growing demand”.

With gold hitting \$1,900 an oz during the year and Brent Crude Oil surging to \$128 as Middle Eastern tension culminated in the Arab Spring, our assumptions were correct but both proved more trading orientated opportunities rather than long term buy and hold strategies, with gold losing much of its lustre

and oil its shine as the US dollar strengthen (we must not forget both are priced in dollars), profit taking and a temporary calm descended within oil producing regions.

IN CONCLUSION

In conclusion 2011 proved one of the most volatile on record and given the poor economic and crisis ridden environment it is surprising that losses for all clients have not been more significant. All aspects of external news have been for the most part negative and the flood of money to perceived safe haven investments of Gold, UK Gilts, German Bunds and US Treasuries has been tantamount to panic. We were happy not too ride the gold story and this is unwinding frantically in the latter part of December. We were wrong on the ferocity of a gilt rally and remained underweight which was our core mistake for 2011. We expect that the weakness of gilts to be a theme of the coming 12-18 months however. The principal negative of the year was the powerful mid-year rally in AAA/AA sovereign bond prices which we did not fully benefit from given our negative longer-term outlook. This we believe will ultimately prove correct, and again underlined our ethos of looking past short term market movements and focusing on medium to longer term trends which we believe should drive our asset allocations policies.

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